

Message Text

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ACTION ARA-10

INFO OCT-01 ISO-00 ARAE-00 AID-05 CIAE-00 COME-00 EB-07

FRB-01 INR-07 NSAE-00 USIA-15 TRSE-00 XMB-04 OPIC-06

SP-02 CIEP-02 LAB-04 SIL-01 OMB-01 NSC-05 SS-15

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P R 191400Z MAY 75

FM AMEMBASSY BRASILIA

TO SECSTATE WASHDC PRIORITY 9293

INFO AMCONSUL RIO DE JANEIRO

AMCONSUL SAO PAULO

AMEMBASSY SANTO DOMINGO

UNCLAS SECTION 1 OF 2 BRASILIA 3909

PASS TREASURY DEPARTMENT

SANTO DOMINGO PASS DE FALCO IDB DELEGATION

E.O. 11652: N/A

TAGS: EFIN, BR

SUBJECT: BRAZIL PERMITS FOREIGN CAPITAL INTO CAPITAL MARKET

1. SUMMARY: BY MEANS OF A DECREE LAW (NO. 1401) SIGNED BY PRESIDENT GEISEL ON MAY 7, BRAZIL HAS OPENED ITS CAPITAL MARKET TO FOREIGN FUNDS. VEHICLE THROUGH WHICH FOREIGN CAPITAL IS TO BE ATTRACTED IS FOREIGN PURCHASE OF SHARES OF INVESTMENT COMPANIES ORGANIZED SPECIFICALLY FOR THIS PURPOSE. MAJOR RESTRICTIONS IMPOSED ON FOREIGN CAPITAL PARTICIPATION ARE: (A) IT MUST BE FUNNELLED THROUGH AUTHORIZED INVESTMENT COMPANIES, (B) IT MUST REMAIN IN BRAZIL FOR A MINIMUM OF (3) THREE YEARS, (C), INVESTMENT COMPANIES CANNOT HOLD MORE THAN 10 PERCENT OF THE VOTING STOCK OR MORE THAN 20 PERCENT OF THE TOTAL CAPITAL OF ANY PRIVATE BRAZILIAN COMPANY. THE UNCLASSIFIED

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TAX TREATMENT OF THIS FOREIGN INDIRECT INVESTMENT

IS SOMEWHAT MORE FAVORABLE THAN THAT ACCORDED TO FOREIGN DIRECT INVESTMENT. PRELIMINARY REACTION TO THIS MOVE HAS BEEN GENERALLY FAVORABLE, WITH THE STOCK MARKET RESPONDING WITH INCREASED ACTIVITY. FINANCE MINISTER SIMONSEN WARNS AGAINST EUPHORIA, SAYING THAT, WHILE FOREIGN CAPITAL CAN HELP STOCK MARKET, IT CANNOT SOLVE ITS FUNDAMENTAL PROBLEMS. HE SAID THESE PROBLEMS REQUIRED MODIFICATION OF CORPORATION LAW, WHICH IS NOW BEING STUDIED. A NUMBER OF FOREIGN BANKS HAVE REPORTEDLY ALREADY REQUESTED PERMISSION TO ORGANIZE INVESTMENT COMPANIES. GUESSTIMATES CIRCULATING IN FINANCIAL CIRCLES PUT THE IMMEDIATE IMPACT ON CAPITAL INFLOW OF THESE MEASURES AT UP TO \$300 MILLION. END SUMMARY.

2. WITH THE ISSUANCE OF DECREE LAW 1401 ON MAY 7, 1975 PERMITTING THE FORMATION OF INVESTMENT COMPANIES FOR THE SPECIFIC PURPOSE OF ATTRACTING FOREIGN FUNDS INTO THE CAPITAL MARKET, BRAZIL TOOK A LONG-WAITED STEP. THIS DECREE LAW, TOGETHER WITH SEVERAL CIRCULARS PUBLISHED SIMULTANEOUSLY BY THE CENTRAL BANK, SET THE FOLLOWING CONDITIONS FOR FOREIGN PARTICIPATION IN BRAZIL'S CAPITAL MARKET;

3. GENERAL CONDITIONS.

A. INVESTMENT COMPANIES MUST BE ORGANIZED FOR THE SPECIFIC PURPOSE OF RECEIVING FOREIGN CAPITAL. THEY NEED AUTHORIZATION FROM THE CENTRAL BANK AND WILL BE REFERRED TO AS "INVESTMENT COMPANY -- DECREE LAW 1401".

B. INVESTMENT BANKS AND BROKERAGE HOUSES MAY SEEK AUTHORIZATION TO OPERATE SUCH INVESTMENT COMPANIES. BROKERAGE HOUSES, IN ORDER TO QUALIFY, MUST HAVE A NET WORTH OF AT LEAST CR\$5 MILLION.

C. TO SET UP SUCH AN INVESTMENT COMPANY, A MINIMUM PAID-IN CAPITAL OF CR\$200,000 AND MAXIMUM AUTHORIZED CAPITAL OF CR\$50 MILLION IS REQUIRED.

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D. FIFTY PERCENT OF THE INVESTMENT BY THE INVESTMENT COMPANIES MUST BE MADE IN STOCK ISSUES OR ON INVERTIBLE DEBENTURES OF PRIVATE, BRAZILIAN - CONTROLLED, OPEN CAPITAL COMPANIES. THE OTHER HALF MAY BE INVESTED IN THE FOLLOWING ASSETS: TREASURY BONDS, DEBENTURES OF PRIVATE BRAZILIAN COMPANIES, STOCKS REGISTERED ON THE LOCAL EXCHANGES, NEW STOCK ISSUES APPROVED BY THE CENTRAL BANK BUT NOT

REGISTERED ON LOCAL EXCHANGES.

E. INVESTMENT COMPANIES' HOLDINGS IN ANY ONE COMPANY MAY NOT EXCEED 10 PERCENT OF THE INVESTMENT COMPANY'S TOTAL INVESTMENT, AND 10 PERCENT OF THE VOTING STOCK OR 20 PERCENT OF THE TOTAL CAPITAL OF ANY GIVEN COMPANY.

F. CAPITAL ENTERING BRAZIL AS OF MAY 8 (DATE ON WHICH NEW REGULATIONS WENT INTO EFFECT) MAY BE HELD IN INTEREST-BEARING DEPOSIT WITH THE CENTRAL BANK FOR 180 DAYS IN THE NAME OF THE INDIVIDUAL INVESTMENT COMPANY, PENDING THE CONCLUSION OF FINAL INVESTMENT.

4. FISCAL CONDITIONS.

A. FOREIGN INVESTMENT MUST REMAIN IN BRAZIL FOR A MINIMUM PERIOD OF THREE YEARS. AFTER THIS PERIOD, THE INITIAL INVESTMENT CAN BE RETURNED TO ITS COUNTRY OF ORIGIN WITHOUT ANY RESTRICTIONS OR TAXATION.

B. DIVIDENDS AND CAPITAL GAINS REMITTED TO FOREIGN RESIDENTS ARE SUBJECT TO THE FOLLOWING DECREASING INCOME TAX SCHEDULE:

...15 PERCENT, IF REMITTANCES MADE BEFORE

SIX YEARS FROM THE DATE THE FUNDS ARE

REGISTERED WITH THE CENTRAL BANK;

...12 PERCENT, IF REMITTANCES MADE

BETWEEN SIXTH AND SEVENTH YEAR;

...10 PERCENT, IF REMITTANCES MADE BETWEEN

SEVENTH AND EIGHTH YEAR;

...8 PERCENT, IF REMITTANCES MADE AFTER EIGHTH

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P R 191420Z MAY 75

FM AMEMBASSY BRASILIA

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C. DIVIDENDS AND CAPITAL GAINS REMITTED TO
FOREIGN RESIDENTS IN EXCESS OF 12 PERCENT (OVER
A THREE-YEAR AVERAGE) OF THE VALUE OF THE INITIAL
INVESTMENT WILL BE SUBJECT TO THE FOLLOWING SUPP-
LEMENTARY INCOME TAX:

...AN EXCESS BETWEEN 12 PERCENT AND 15

PERCENT: 40 PERCENT SUPPLEMENTARY TAX;

... AN EXCESS BETWEEN 15 PERCENT AND 25 PERCENT:

50 PERCENT SUPPLEMENTARY TAX;

...AN EXCESS OF OVER 25 PERCENT: 60 PER-

CENT SUPPLEMENTARY TAX.

D. THE SUPPLEMENTARY INCOME TAX IS REDUCED TO
ZERO ON DIVIDENDS AND CAPITAL GAINS REMITTED AFTER
EIGHT YEARS FROM THE DATE ON WHICH THE INITIAL INVESTMENT
WAS REGISTERED WITH CENTRAL BANK.

COMMENT

5. REGULATIONS ALLOWING FOREIGN FUNDS INTO THE
CAPITAL MARKET HAD BEEN EXPECTED FOR SOME TIME.

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THERE HAD BEEN A NUMBER OF LEAKS TO THE PRESS TO THIS
EFFECT FROM PRIVATE FINANCIERS WHO WERE REPORTEDLY
SHOWN A DRAFT OF THE REGULATIONS BY THE GOVERNMENT
SEEKING PRIVATE SECOT SECTOR COMMENTS. JUDGING FROM THE
VERY PRELIMINARY REACTIONS FROM THE FINANCIAL
COMMUNITY AND FINANCIAL PRESS, THERE SEEMS TO BE
GENERAL SATISFACTION WITH THE WAY THE GOVERNMENT CHOSE
TO REGULATE FOREIGN FUNDS IN THE CAPITAL MARKET, BUT THERE

HAS BEEN LIMITED CRITICISM FROM OPPOSITION QUARTERS (ROBERTO SATURNINO BRAGA, MDB SENATOR, FROM RIO), WHO TERMED THE GOVERNMENT'S MOVE "UNFORTUNATE" BASED ON AN INCORRECT UNDERSTANDING OR MISINTERPRETATION OF THE MEASURE. INFORMED CRITICS, HOWEVER, RECOGNIZE THAT THE LIMITS OF 10 PERCENT OF THE VOTING STOCK OR 20 PERCENT OF TOTAL CAPITAL, WHICH MAY BE HELD BY FOREIGN CAPITAL THROUGH INVESTMENT COMPANIES, REPRESENT AN ADEQUATE SAFEGUARD AGAINST THE DENATIONALIZATION OF BRAZILIAN INDUSTRY.

6. IT SHOULD BE NOTED, THAT WHILE THIS 10 PERCENT/20 PERCENT LIMIT MAY BE PROVIDE A HEDGE AGAINST DENATIONALIZATION, IT WILL, AT LEAST INITIALLY, ALSO PROVE A CONSIDERABLE BARRIER TO ANY SIZEABLE INFLOW OF FOREIGN FUNDS. GIVEN THE LIMITED DEPTH OF THE BRAZILIAN STOCK MARKET, WE EXPECT THAT FOREIGN INTEREST WILL AT FIRST BE CONCENTRATED ON THE MORE "SOLID" STOCKS. ONLY OVER THE MEDIUM AND LONG-TERM, AFTER FOREIGNERS HAVE BECOME TRULY FAMILIAR WITH THE BRAZILIAN CAPITAL MARKET AND AFTER MAY OF THE FUNDAMENTAL WEAKNESSES OF THE MARKET ITSELF ARE OVERCOME, WILL THE FULL IMPACT OF THESE MEASURES BE REALIZED. GUESSTIMATES CIRCULATING IN THE FINANCIAL PRESS PUT THE IMMEDIATE CAPITAL INFLOW RESULTING FROM THESE MEASURES AT UP TO \$300 MILLION. WHEN SIMONSEN WAS ASKED ABOUT THIS FIGURE, HE REPLIED THAT UNDER THE CIRCUMSTANCES IT IS IMPOSSIBLE TO MAKE ANY ESTIMATE. A NUMBER OF AMERICAN BANKS, INCLUDING FIRST NATIONAL CITY AND THE BANK OF BOSTON, HAVE REPORTEDLY ALREADY SOUGHT CENTRAL BANK PERMISSION TO SET UP INVESTMENT COMPANIES.

7. ALTHOUGH THE FISCAL TREATMENT OF THIS NEW (INDIRECT) INVESTMENT FOLLOWS THE SAME GENERAL UNCLASSIFIED

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TAX PHILOSOPHY NOW APPLIED TO DIRECT INVESTMENT, THERE ARE SOME SIGNIFICANT DIFFERENCES BETWEEN THE TWO. IN THE CASE OF THE REGULAR INCOME TAX ON REMITTED DIVIDENDS AND CAPITAL GAINS (WHICH IS APPLIED ON REMITTANCES NOT EXCEEDING AN AVERAGE OF 12 PERCENT OVER A THREE-YEAR PERIOD), THE APPLICABLE RATE WILL BE AT 15 PERCENT, WITH A DECREASING RATE FOR REMITTANCES MADE AFTER SIX YEARS FROM THE DATE THE INVESTMENT WAS REGISTERED WITH THE CENTRAL BANK. PROFIT REMITTANCES FROM DIRECT INVESTMENT, ON THE OTHER HAND, WILL CONTINUE TO BE TAXED AT 25 PERCENT, WITHOUT ANY PROGRESSIVE DECREASES. WITH RESPECT O TO THE SUPPLEMENTARY INCOME TAX (WHICH IS APPLIED ON REMITTANCES OVER THE 12 PERCENT BASE) REMITTANCES FROM INDIRECT INVESTMENTS WILL BE TAXED

AT THE SAME DATES AS THOSE NOW APPLIED ON PROFIT
REMITTANCES. THE ONLY DIFFERENCE INSOFAR AS THE
SUPPLEMENTARY RATE IS CONCERNED IS THAT IT IS
REDUCED TO ZERO AFTER EIGHT YEARS; WHILE IN THE
CASE OF PROFIT REMITTANCES ON DIRECT INVESTMENT,
THE SUPPLEMENTARY TAX REMAINS THE SAME REGARDLESS
OF THE NUMBER OF YEARS THE INVESTMENT HAS BEEN IN
COUNTRY.
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